



January 31, 2006

Hon. Bill Maze
Assembly Member, 34th District
Room 4015, State Capitol
Sacramento, California 95814

Dear Assembly Member Maze:

You have asked us to provide you with General Fund revenue and expenditure projections covering the next ten years, assuming no new bonds or new debt service during this period.

Before discussing our assumptions and presenting our results, we note that the analysis that you are requesting takes place in an unusual fiscal environment which has important implications for our bottom-line. Specifically, as we indicated in January, the state faces an ongoing structural budget shortfall, where annual expenditures in 2006-07 and 2007-08 are projected to exceed revenues by over \$5 billion, absent corrective policy actions. As a result, even though we expect revenues to grow modestly faster than expenditures in the future, it will be a number of years before annual revenues rise by enough to support the program commitments (exclusive of the new bond proposals) included in the Governor's budget proposal. Until the state eliminates these projected annual shortfalls, new proposals for infrastructure or any other purpose would necessarily involve even more significant policy trade-offs than normally would be the case.

Assumptions

Our office is currently developing updated long-term fiscal forecasts that will be released in our *2006-07 Budget: Perspectives and Issues* document in late February. In order to meet the accelerated time frames of your request, however, we used the preliminary fiscal estimates we prepared in January for 2007-08 and 2008-09 for the purpose of our initial review of the Governor's budget, and then developed somewhat aggregated fiscal projections for the out-years. The out-year estimates are based on trend forecasts of economic growth, inflation, revenues, population, and program caseloads for the period. Our baseline estimates are also based on the following three key assumptions:

- *First*, they generally assume that the policies embodied in the *2006-07 Governor's Budget* proposals (exclusive of the new bonds) are continued in

2007-08 and beyond. They do not include the impacts of corrective actions that would be needed to bring out-year budgets into balance.

- *Second*, they include the debt service associated with both (1) current bonds outstanding and (2) sales of bonds already authorized by the voters (for which much of the money has already been committed) but that have not yet been sold. They do not, however, include the debt-service costs associated with any new bond authorizations in 2006 and beyond, such as those proposed by the Governor. We have included the authorized but as-yet-unsold bonds in our baseline expenditure forecast because the voters have already decided that these bonds should be used for their stated purposes, and the fact that they have not yet been sold is largely a timing issue.
- *Third*, they include the Governor's proposal to fund the transfer to the Budget Stabilization Account (BSA) beginning in 2006-07, and use one-half of these transfers to accelerate repayment of the deficit-financing bonds.

Regarding this third assumption, the accelerated bond payments (totaling \$460 million in 2006-07, \$975 million in 2007-08, \$1.5 billion in 2008-09, and \$1.7 billion in 2009-10) are significant in that they would enable the state to fully pay off the deficit-financing bonds by the end of 2009-10. This in turn would result in the General Fund-related expenses associated with the so-called "triple flip" concluding at the close of 2009-10, saving the state roughly \$1.8 billion annually thereafter. This would leave more money available for infrastructure or other purposes. Should the state not fund the BSA transfers and/or issue any of the \$3.7 billion in remaining deficit-financing bonds, bond repayments would continue for additional years—leaving less room in the budget for capital outlay debt service or other purposes.

Results

Our projections show that revenue growth will modestly outpace expenditure growth over time. As indicated in Figure 1 and Figure 2:

- Over the full ten-year period you identified, revenues would grow at an average annual rate of 6.1 percent, or slightly *more* than the 5.8 percent average growth in the state's economy (as measured by personal income). This slightly faster rate for revenues compared to the economy is largely a reflection of the state's progressive personal income tax, where rising income levels are subject to higher marginal tax rates.
- Over the same ten-year period, baseline expenditures are projected to grow at an average rate of roughly 5.5 percent annually, or slightly *less* than statewide personal income growth.

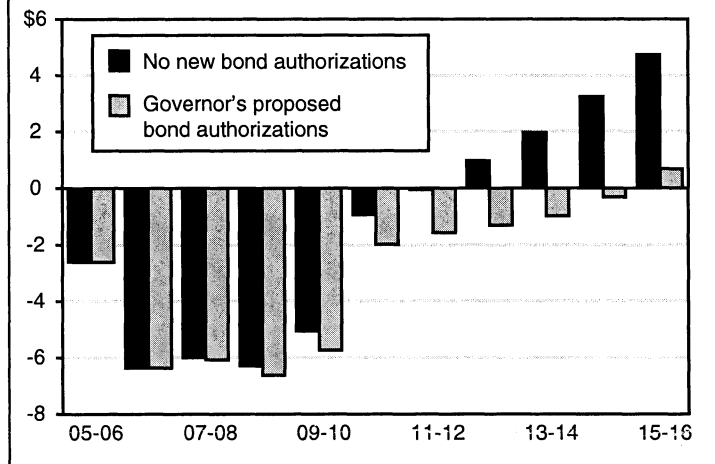
Figure 1
General Fund Revenues and Expenditures

(Dollars in Billions)

	Governor's Budget		Projections		Annual Average Change
	2005-06	2006-07	2011-12	2015-16	
Revenues	\$87.7	\$92.0	\$124.9	\$158.3	6.1%
Expenditures:					
Baseline (no new bond authorizations)	90.3	98.4	124.9	153.5	5.5
With Governor's proposal	90.3	98.4	126.5	157.6	5.7

Figure 2
General Fund Operating Balances

(In Billions)



- If the Governor's proposal for new borrowing is included, total expenditures would increase at a slightly higher average annual growth rate of 5.7 percent.
- Even assuming a healthy economy and the more rapid revenue growth rate it would produce, the state would continue to incur annual shortfalls until 2011-12. This assumes revenue and expenditure projections hold and there were no new bond authorizations. The annual budget shortfalls would need to be addressed somehow through budget-balancing actions.
- Beginning in 2012-13, the higher revenue growth rate relative to expenditure growth would produce annual surpluses, which could be devoted to infrastructure or other purposes. However, as indicated in

Figure 2, if the Governor's proposed bond authorizations were adopted and sold according to his planned schedule, the state would experience annual operating shortfalls until 2015-16, when revenues would finally cover expenditures. The costs associated with the Governor's proposal start at \$76 million in 2007-08 and ramp up to \$4 billion by 2015-16, by which time most of the bonds would be sold.

Total Cost of Debt Service on \$68 Billion in Bonds

Assuming, as the Governor does, that the bonds were fixed-rate bonds that carried an average 5.75 percent interest rate and were repaid with level payments over 30 years, the total payments over the life of the bonds would be about \$144 billion, including \$68 billion to repay the principal and \$76 billion in interest. The payments would be made over many years, so the total cost in "today's dollars" (that is, after adjusting for inflation) would be less. The *annual* debt-service costs would reach about \$4.8 billion when all the bonds were sold. Under the Governor's plan, this would take more than ten years to occur.

Should you have any questions about these preliminary estimates, please feel free to call me at 445-4656 or Brad Williams of my staff at 319-8306. In addition, we would be happy to meet with you to discuss in more detail the above information.

Sincerely,



Elizabeth G. Hill
Legislative Analyst

Enclosures